Turkey: A bigger-than-expected cut, again

The Central Bank of Turkey cut the policy rate by 200 basis points to 12.0% at the December meeting, bringing the cumulative cut in the last four meetings to 1200 basis points

-200bp CBT policy rate change

to 12%

The decision

In the last rate setting meeting of the year, the Central Bank of Turkey (CBT) cut interest rates more than expected, as it has done in other meetings since July, pulling the policy rate (1-week repo rate) down by 200 basis points to 12.0%. This compares to the market consensus of 150bp (and our call of 100bp), while forward implied yields were pricing more than 300bp. This move should be supported by the November inflation data, which in turn will suggest that inflation has remained below the CBT's estimate for this year, despite the possibility of a further increase in December amid an unsupportive base.

With the decision, the CBT reiterated its commitment to sustained disinflation, which will help to reduce sovereign risk, lower long-term interest rates and support a stronger economic recovery. Given earlier signals, this commitment also includes “a reasonable rate of real return”. Against this backdrop, with the revised policy rate at 12.0%, the ex-post real policy rate will be at 0.5 percentage point in December if we pencil in our CPI forecast of 11.5%. So, the case for further monetary easing in early 2020 has significantly weakened after the December decision given 1)Turkey’s emerging market peers average for the same indicator stands around 2.3 percentage points 2) likely less supportive inflation outlook in early 2020 amid a weaker base and improving demand conditions.

Inflation and economic outlook

Regarding the inflation outlook, the CBT remains optimistic, citing continued improvement and a “wide-spread decline” in inflation expectations. However, it says core inflation indicators “have displayed a mild trend” amid “the stable course of the Turkish lira as well as the developments in domestic demand conditions and producer prices”. At the same time, factors have supported “the disinflation in core indicators,” according to the October statement. Accordingly, the bank now envisages the end-2019 inflation to be close to the lower bound of the latest inflation report predictions, and risks around the disinflation path for 2020 are balanced.

For economic activity, the CBT sees 1) continued improvement in the diffusion of activity across sectors 2) weak investment demand 3) support from improving competitiveness of goods and services exports, reducing the impact of a weakening global economic outlook and 4) a decline in the contribution of net exports. This, coupled with the disinflation trend and the improvement in financial conditions, has led the CBT to maintain its view that the recovery in economic activity is likely to be sustained. Meanwhile, the latest macro prudential move to support lending shows that the CBT will maintain its focus on a “stronger economic recovery” with a real credit growth objective in the 5-15% range on a three-month rolling basis, with adjustments in the reserve requirement framework.

Finally, the CBT kept its key guidance sentences unchanged, stating that “at this point, the current monetary policy stance, to a large part, is considered to be consistent with the projected disinflation path”.

> Overall, thanks to a significant improvement in inflation dynamics (due to a correction in food prices as well as a stable currency and weak demand) the CBT has become more confident about the strength of disinflation and implemented a deeper-than-expected easing cycle since July. However, the bank will likely turn cautious in the near term given likely stickier inflation readings with a less supportive base, low ex-post real policy rate as well as ongoing high dollarisation and subdued capital flow outlook.

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